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TROUBLE BREWING

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BUSINESS

To perk up sales, Starbucks has big plans to expand on the Internet and overseas

In the hall of mirrors that Wall Street can be, Howard Schultz apparently thought he had it figured out. Bury the bad news, go with the good. Just before July 4, the CEO of Starbucks ran a conference call with analysts and announced that profits for the current fiscal year would be 10 percent below expectations, the result of an expensive Internet start-up and an unspectacular Frappuccino supermarket thrust. But what was the big deal, especially since the company was still making tens of millions? So Schultz used his hour of phone time to boast about Starbuck's plans to ultimately harness the Internet. Starbucks, he said, aimed to create nothing less than the "premier lifestyle portal on the Internet"--a place that offers "a feeling of romance, of relaxation," an amalgam of storefronts at which to buy not just overpriced coffee, but overpriced kitchenware, home furnishings and gourmet food.

Unfortunately, Wall Street didn't smell the aroma of Colombia Narino Supremo; instead, it sensed that the company may be losing its way. Analysts roasted Schultz, investors dumped Starbucks and the share price



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fell 28 percent in one day. That translated into an almost \$2 billion loss in the company's market capitalization--almost \$50 million for Schultz alone. He'll still be able to afford Venti Mocha Valencias--\$4.90 in our neighborhood. But Mr. Starbucks had the unwanted distinction of actually making the Internet seem financially unappealing. In an age where every company wants to dot.com itself and cash in, Starbucks had managed to perform reverse alchemy. The reason is simple: after a decade of phenomenal growth in its North American cafe business, Starbucks now has to figure out an Act II. It is aggressively looking to expand its international business, which alone is grounds for concern. Will Venetians and Parisians really care for McCoffee? As for the Internet, most folks were left to wonder why anybody would buy an armoire from Starbucks any more than they'd get coffee from Ikea.

The foray into the Internet--on which Starbucks has already spent \$4 million--is based on the company's assumption that its brand name in coffee can be extended to other "lifestyle" products. Earlier this year Starbucks was reportedly negotiating to buy Williams-Sonoma, the upscale retailer of kitchenware goodies. Whether that happens, Starbucks still plans to include on its Web site high-end retailers whose products coincide with the Starbucks lifestyle. Exactly who those retailers might be and when their products might be available will be announced later this summer. This marketplace, Schultz argues, is worth "more than \$100 billion" and is "enormously attractive, given the natural synergies with our core customer demographics." Anybody using the word synergies ought to be suspect, but Schultz's gambit is that his legion of Yuppie customers--call them Cuppies--will rely on him to fashion the ultimate online mall.

Starbucks got its start in Seattle in 1971. But it wasn't until the late 1980s that the company launched its revolutionary retail and marketing concept. Like that other local business success story Microsoft--which promised a computer in every home--Starbucks seemed to want a coffee bar on every street corner. If it worked for burgers--McDonald's has 13,700 North American stores--why not java? Naysayers scoffed that consumers would pay double for a product easily purchased at a deli. But the 45-year-old Schultz--who grew up in the Brooklyn projects and initially was Starbuck's marketing director--laughed all the way to Millionaires Row in Seattle. The company went public in 1992.

The number of North American stores--almost all in the United States--increased from 17 at the end of 1987 to more than 2,000 today. Even though sales at stores open at least a year are up 5 percent, the rate of growth is slowing. It has to be--at a certain point, new stores in a given city will only be competing against established ones. Moreover, sales in supermarkets of its much-advertised Frappuccino bottled drink haven't fulfilled expectations. The disappointing earnings estimate caused the company's Wall Street brouhaha. While consistent profits ought to impress investors, the Street is Oliver Twist: it always wants more, at least if it's going to support caffeinated stock prices. The reckoning for Starbucks came in its pre-Independence Day announcement. In his hourlong call with analysts, Schultz was enthusiastic about his company's Internet plans. But, for the moment, his decision not to spell them out undercut whatever value they may ultimately have. Schultz declined repeated requests from NEWSWEEK for additional comment and a company spokesman declined to elaborate on Schultz's remarks, though he did make available a

tape of Schultz's phone calls with analysts.

Apart from its Internet strategy, Starbucks's international plans tie more into its core coffee business. But they're no less ambitious. There are currently 217 outlets outside North America--most in Japan and the United Kingdom, a few in such far-off lands as China, Taiwan, Thailand, New Zealand and Kuwait. By the end of the year Starbucks plans at least 100 more. Someday, Schultz said, there will be 10,000 Starbucks shops worldwide. If Coke exported so well--it is the ultimate global brand--why not coffee? When the first Starbucks abroad opened, in 1996 in Tokyo, Schultz himself attended. He and other executives cleansed their hands with natural spring water, drank sake and watched in delight as Shinto priests offered prayers to help bring alignment between Starbucks and the forces of nature.

Continental Europe has no stores yet. Italy and France are coffee paradises, but, well, have their own coffee cultures that may not welcome a venti Americano competitor when it arrives next year. "American chain," laughs the dashing young barman of Bar du Marche in Paris. "We are unique! This is Paris!" Yet Howard Behar, president of Starbucks International, won't even rule out the small Italian coffee shops that initially inspired Schultz during a trip to Milan 16 years ago. "Italy didn't create coffee," Behar says. "Nobody owns coffee."

China represents the great opportunity, both because of its population and the fact that until recently coffee was considered a Western bourgeois trapping. The country's coffee drinking has doubled in the past four years, but it still only amounts to about one cup per person per annum, and the brand typically is instant Nescafe. There's also the problem of thinking about a cappuccino with chow mein. Yuck. Tea sounds a lot better. "Coffee doesn't go well with Chinese food," admits Catherine Chau, vice president of Starbucks's partner in Beijing, "but it can be its own experience." Maybe someday even a "lifestyle." Now if only Howard Schultz can interest the Chinese in deluxe countertop pastamakers.

Stocking the Shelves

No soup or nuts, but Starbucks is already trying to tempt shoppers with an ever-expanding product line. The merchandising mania will only increase on the Internet

Ground Down

A warning about profits surprised Wall Street and sent the stock plunging.

GRAPH: CLOSING STOCK PRICE (4/15/99-7/9)

PHOTO (COLOR): Reading matter

PHOTO (COLOR): Frappuccino fade

PHOTO (COLOR): Dunking Doughnut

PHOTO (COLOR): Some tunes to sip to

PHOTO (COLOR): A mug for your mocha

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By DAVID A. KAPLAN

With Katrina Woznicki in Seattle and bureau reports

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